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Policy issues for the Asia-Pacific region: Economic and Social Survey of Asia and the Pacific 2014

Summary of the Economic and Social Survey of Asia and the Pacific 2014

Note by the secretariat**

Summary

The average growth rate of the developing economies of Asia and the Pacific is forecast to rise moderately in 2014. However, in line with the wide diversity in the region, growth performances will vary across subregions and countries.

More rapid growth in the region is being held back by a number of factors. First, slow growth in advanced economies continues to negatively affect exports and the financial sector. Second, the tapering of quantitative easing by the United States of America is putting further pressure on the recovery of several economies by causing significant capital outflows. Third, economies are facing a number of domestic challenges, especially some of the larger developing economies, in such areas as infrastructure shortages, large budget deficits, inflationary pressure and rising and persistent inequality.

With constrained growth prospects, productive government spending is critical to support inclusive growth and sustainable development. Unlocking the fiscal space for such spending poses a challenge that the *Survey* seeks to examine. It is done by analysing how countries can raise more tax revenues given that taxes in most countries in the region are neither sufficient nor equitable. Estimates in the *Survey* indicate that a large number of countries have significant tax potential. Tapping this would enable tax revenues to rise by at least 70% in several of them.

Tax revenues may be enhanced through a number of policy measures. Among them in particular are broadening tax bases and rationalizing tax rates in order to provide greater incentives for tax compliance. Strengthening regional tax cooperation would further boost revenues as it would reduce tax competition and the illicit transfer of funds.

A key argument in the *Survey* is the need to make tax administrations more effective and transparent in order to tackle tax evasion and tax fraud. The *Survey* contains a number of policy options for sequencing tax policy reforms and tax administration along with a call to establish special tax courts to deal with tax fraud expeditiously. Also presented in the *Survey* is the case for establishing an Asia-Pacific tax forum, under the aegis of ESCAP, to monitor the tax legislation of member countries and publish a regular review of tax reforms with a view to harmonizing tax regulations and sharing best practices.

The Commission may wish to deliberate on the issues raised and policy proposals in the present document and how these recommendations can be strengthened for the shared benefit of member States.

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** The late submission of the present report is due to the non-availability of 2014 data by the submission deadline.

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I. Introduction

1. In 2014, the average growth rate of developing economies of Asia and the Pacific is forecast to rise to 5.9%.¹ This represents a modest increase of 0.3 percentage points from 2013. Reflecting the diversity of the region, growth performances are projected to vary substantially among subregions and economies. While growth in South and South-West Asia and developing Pacific economies is expected to improve, the other subregions are likely to experience a stable or slowing performance.

2. Although the developing Asia-Pacific economies continue to anchor the global economic recovery, both external and internal factors are holding them back from achieving more rapid growth. Apart from a slow recovery in developed economies, capital outflows stemming from a change in the

¹ The forecasts and data are as of 8 May 2014.

monetary policy of the United States of America pose difficulties for a number of economies. Growth in some large developing economies in the region is also challenged by domestic structural impediments.

3. Growth and macroeconomic stability in the region continue to be affected by policies and low growth in the developed world. Concerns about a reduction in quantitative easing (referred to as "tapering") by the United States Federal Reserve caused significant asset market volatility in September 2013 and then again in January 2014. Countries responded with a mix of policies — letting currencies depreciate, use of foreign exchange reserves and interest rate rises.

4. In 2013, some of the region's major economies were also affected by domestic challenges. These include infrastructure shortages, large budget deficits, inflationary pressure, inadequate expansion of good quality jobs in the formal sector and rising inequality. The constrained domestic growth prospects of the region underline the important role of productive government spending in efforts to achieve inclusive growth and sustainable development. A critical challenge will be the funding of the necessary development programmes.

5. The *Survey* analyses in detail how to raise domestic resources, in particular expand fiscal space. Countries especially need to strengthen tax collection, as levels of tax revenue are currently neither sufficient nor equitable. Analysis of the level and composition of existing tax revenues in countries of the region demonstrates that many countries have significant tax potential. Tapping this would enable tax revenues to rise by at least 70% in several countries. While some tax exemptions and concessions are useful, many are depressing tax revenues. Moreover, unless foreign investors can offer something extra compared with domestic investors, preferential tax treatment of foreign investors only distorts competition and puts local companies at a disadvantage.

6. Tax revenues may be enhanced through a number of policy measures, such as broadening tax bases, rationalizing tax rates to provide greater incentives for tax compliance, expeditious dealing with tax evasion and tax fraud, and making tax administrations more effective and transparent. In this context, an outline of a strategy for sequencing reforms of tax policy and tax administration, including establishing special tax courts, is contained in the *Survey*. It is also argued that strengthening regional cooperation would enable countries to raise levels of tax revenue by stemming tax competition and the illicit transfer of funds. In this regard, a proposal to establish an Asia-Pacific tax forum under the aegis of ESCAP is made.

7. The following summary of the *Survey* is divided in four sections. In section II, the challenges facing the region are considered in greater detail. The section begins with a discussion of growth prospects in developed countries and the potential for spillover of developed countries' policies to the region. It then provides a review of growth and inflation prospects in the region, followed by the outlook for regional trade developments and prospects for foreign direct investment. Section III contains a discussion on some of the major socioeconomic challenges in the region, such as the problems of job creation and inequality. In section IV, policy recommendations to address some of these issues are provided, namely productive government spending to directly support growth in the short-term while helping to address structural challenges affecting growth in the long-term, measures to address youth unemployment, and policies to manage the risks from volatility in financial flows.

8. In section V, greater depth of the findings of the *Survey* on how to expand fiscal space is provided. It begins with an explanation of why strengthening tax revenues may be the most promising path to create fiscal space in the region, and then contains a discussion on how the composition of revenues matters as much as their level. This is followed by a presentation of estimates of the tax potential in selected countries of the region, highlighting those countries that are currently collecting lower tax revenues than would be appropriate given their economy's structure. The section concludes with a presentation of policy options for countries to enhance their tax revenues.

II. Growth recovery under pressure

A. Slow growth and policies of developed economies impacting the region

9. Growth in Asia and the Pacific in 2013 was affected by slow growth in the major developed economies — the United States, the eurozone and Japan. Given the importance of these economies in terms of trade and investment linkages, their continued slow recovery remains a concern for the region. It will be challenging to significantly increase growth in the major developed economies in the near-term. A surge in consumer demand is unlikely to occur in the United States and the eurozone with joblessness remaining high. While the financial markets in the eurozone were reasonably calm in 2013, risk of macroeconomic instability stemming from renewed loss of confidence by investors in resolving debt issues persists. Furthermore, there are differing views regarding the possibility of deflation in the eurozone.² Within Asia and the Pacific, the growth outlook for Japan depends on the impact of an ongoing reform programme, which includes a hike in the sales tax implemented in April 2014 and a range of policies to change the country's economic structure yet to be announced.

10. Policies in the developed world also had a significant impact on the region through spillovers from tapering by the United States. In January 2014, there was an episode of capital outflows from the region, with the greatest equity market falls occurring in Turkey (7.7%) and in India (4.4%). This followed a more widespread exit of funds in the third quarter of 2013 on expectations by the financial markets that tapering would start in September 2013. The Turkish equity market experienced the greatest decline (25%) during the period June-August 2013, followed by Indonesia and Thailand (nearly 20%). In August 2013 alone, stock market capitalization in the region declined by more than \$323 billion as compared to the previous month.

B. Domestic impediments to growth

11. Growth in the Asia-Pacific region in 2013 was also affected by relatively tepid growth in some major regional economies due to domestic challenges. Some of the major challenges are infrastructure shortages, large budget deficits, inflationary pressure, inadequate job creation in the formal sector and rising inequality.

12. Infrastructure shortages have led to significant gaps in productive capacity. These gaps have contributed to inflationary pressures. Inadequate growth in formal sector jobs and the rise in informal or vulnerable jobs constrain sustainable expansion of domestic demand when external demand is

² International Monetary Fund, "Euro Area — "Deflation" Versus "Lowflation". Available from blog-imfdirect.imf.org/2014/03/04/euro-area-deflation-versus-lowflation/.

faltering. Research confirms that rising inequality is harmful to economic stability and growth. The *Survey* finds a positive association between inequality (Gini coefficient) and household debt.

13. Relatively slow growth in China, India and Indonesia compared to the pre-crisis level affected economic growth in smaller countries due to their dependence on those larger economies through regional value chains.

C. Region's growth and inflation prospects

14. Growth in the region in 2013 increased slightly to 5.6% from 5.4% in 2012. There was, however, variation in the growth rate by subregion. In East and North-East Asia, a highly trade-dependent subregion, growth edged up, benefiting from improved global growth prospects. The deceleration in growth that had been experienced by China since 2010 came to a halt in 2013, while growth in most other economies improved. The subregion as a whole is projected to post steady growth in 2014, although the economies of China and Japan could grow modestly. China is unlikely to return to the pre-crisis growth rates in the short to medium-term as the country plans to put more effort into rebalancing growth and increasing the share of domestic demand, particularly through consumption. Recent structural reforms, such as the transformation of China towards a market-based system and the effort of the Republic of Korea to promote corporate investment and job creation, should help enhance the subregion's medium-term growth prospects.

15. Growth in South-East Asia slowed to 5% in 2013 from 5.5% in 2012 as the sluggish global economic recovery held back exports, particularly in the first half of the year. Growth in domestic demand also decelerated in large emerging economies, such as in Indonesia, due to monetary tightening in response to higher inflation and capital flight, and in Thailand, on the back of rising household debt and political uncertainty. In contrast, the economy of the Philippines grew rapidly despite being hit by Typhoon Haiyan in late 2013. The least developed countries in the subregion — Cambodia, the Lao People's Democratic Republic, Myanmar and Timor-Leste — maintained high growth rates, underpinned in part by steady foreign investment inflows. In 2014, growth rates of the economies of the subregion are expected to remain largely unchanged, as an anticipated rebound in exports on the back of stronger global demand may be counterbalanced by ongoing financial market volatility.

16. North and Central Asia recorded slower growth of 2.1% in 2013 compared to 3.8% in the previous year. The resource-based economies, particularly the Russian Federation, were affected by subdued global demand for energy, gold and metals. Meanwhile, the fiscal balance of a number of the subregion's economies was affected by an increase in public spending, especially on social programmes, made as part of efforts to sustain domestic demand. In net energy-importing economies, output growth declined owing to subdued household spending. This was partially due to a deceleration in remittances in line with slowing growth in the Russian Federation, the largest host of migrant workers in the subregion. Output growth in the subregion is expected to decline further in 2014 primarily due to the impact of ongoing geopolitical instability on the economy of the Russian Federation, which is projected to grow at only 1%. Due to their strong links with the Russian Federation, several other economies of North and Central Asia are also expected to experience slower growth.

17. Growth in South and South-West Asia picked up to 3.9% in 2013 from 3.4% in 2012. Stronger growth in India, Maldives, Sri Lanka and Turkey can be attributed to increased household spending supported by steady farm incomes and remittances. Energy shortages have constrained economic

activities in several economies. Political tension and security issues adversely affected growth in Afghanistan, Bangladesh, Nepal and Pakistan. Tapering in the United States triggered capital market volatility in India and Turkey, which underscored weak macroeconomic fundamentals, such as large current account deficits that were financed by short-term external borrowing. Room for fiscal manoeuvrability is limited in those countries given their large fiscal deficits. Growth in the subregion is projected to further increase in 2014 subject to a stronger global economy and improved household consumption and investment. Tackling supply-side constraints, especially energy shortages, is vital to future growth.

18. Growth in Pacific island developing economies dipped to 4% in 2013 from 5.3% in 2012, mainly due to an economic slowdown in the resource-rich economies of Papua New Guinea and Solomon Islands. Natural disasters also constrained economic expansion in Fiji and Samoa. The 2014 outlook for the economies of this subregion is brighter, commensurate with the prospects of the global economy. Heavy reliance on imported food and fuel together with limited export capacity generally resulted in sizeable current account deficits among the Pacific island economies. Key development challenges for the subregion in general are poor resource bases, remoteness from global markets, weak public services delivery and high vulnerability to natural disasters and climate change.

19. Inflation differed substantially across the region in 2013. In South-East Asia and East and North-East Asia, it remained low due to constrained global demand. Low inflation enabled most of these economies to implement an accommodative monetary policy, which entailed keeping interest rates stable or reducing them. On the other hand, inflation rates were generally high in South and South-West Asia, forcing policymakers to tighten monetary policy. The 2014 inflation outlook for the region as a whole is generally moderate. However, a number of the major economies, such as Bangladesh, India, Indonesia, Pakistan and Viet Nam, are expected to continue to face significant price pressures.

D. Gradual trade recovery

20. Exports from the region are expected to pick up in 2014 as the medium-term prospects for global trade improve on the back of the ongoing recovery in major developed countries. One of the key factors preventing an even more favourable outlook for trade is limited progress in the Doha Round of multilateral trade negotiations. The multilateral trading system has remained fragmented as seen at the Ninth Ministerial Conference of the World Trade Organization (WTO), which was held in Bali, Indonesia, from 3 to 7 December 2013. Furthermore, ESCAP analysis indicates that export growth of the region is being hampered significantly by non-tariff trade protectionist measures globally and in the region, as well as by relatively high trade costs.

21. Intraregional trade has expanded in recent years helped by greater integration stemming from harmonization of rules and standards. This has been especially noticeable between the ASEAN economies and the rest of the region. A factor of critical importance for the region's trade relationships is likely to be Chinese reform policies directed at improving the quality of growth by promoting domestic consumption. This could deliver significant benefits for exporting economies in the region, especially those that export consumer goods.

22. Least developed countries' low share of Asia-Pacific trade continues to be a concern. These countries account for only 0.7% of total regional exports, valued at \$50 billion in 2012. Therefore, more effort must be put into integrating those

countries into regional supply chains, which can be done by granting them preferential market access and improving their productive capacity. At the same time, there needs to be better connectivity through improved hard and soft infrastructure in order to deepen trade integration across countries and subregions.

E. Positive outlook for foreign direct investment

23. Foreign direct investment (FDI) inflows to the developing economies of the region rose slightly in 2013. Asia and the Pacific remained the largest recipient region of global FDI flows, accounting for nearly one quarter of global FDI. However, the Pacific subregion has been drawing less than 1% of the region's FDI inflows. Intraregional FDI flows within Asia and the Pacific are on the rise, with the ASEAN economies and China being especially attractive destinations to Asian investors.³

24. Falling Greenfield FDI and possible effects of FDI in agriculture are concerns. Greenfield FDI usually provides more direct benefits compared to cross-border mergers and acquisitions by creating new investment through the establishment of production facilities. FDI in agriculture has in some instances led to the displacement of smallholders and damage to the environment. The World Bank has highlighted the danger of land acquisitions that neglect local people's rights and the susceptibility of smallholders to manipulation by investors.⁴ Appropriate policies should be put in place to safeguard against speculative land investments or acquisitions, as well as to prevent environmental degradation.

25. In addition to FDI, there is growing scope for foreign exchange earnings from remittances and tourism. Remittances to developing economies in the region increased to \$265 billion in 2013 from \$49 billion in 2000. Asia and the Pacific is the highest remittance-receiving region in the world, both in absolute and relative terms. International tourism receipts increased to \$320 billion in 2013 from \$169 billion in 2004. For many economies in the region, especially in the Pacific, the level of dependence on the tourism sector and related services is significant at about 20% of GDP.

26. Thus, both remittances and tourism have the potential to play an important role in development in the region. Policymakers, however, must be cognizant of possible drawbacks, such as brain drain and adverse socioecological consequences. For example, manpower exports may exacerbate brain drain while remittances could widen income disparities if they are not invested in productive resources. Similarly, uncontrolled expansion of tourism may have adverse ecological and social consequences.

III. Socioeconomic developments

A. Jobs growth and quality still show mixed progress

27. Low formal sector job creation is a major socioeconomic issue in the region. Both before and after the crisis, GDP growth in the region was not accompanied by a commensurate expansion in formal sector employment. This can be attributed to technological change and labour substitution, as well as to

³ United Nations Conference on Trade and Development, *Global Investment Monitor*, No. 15 (28 January 2014). Available from unctad.org/en/PublicationsLibrary/webdiaeia014d1_en.pdf.

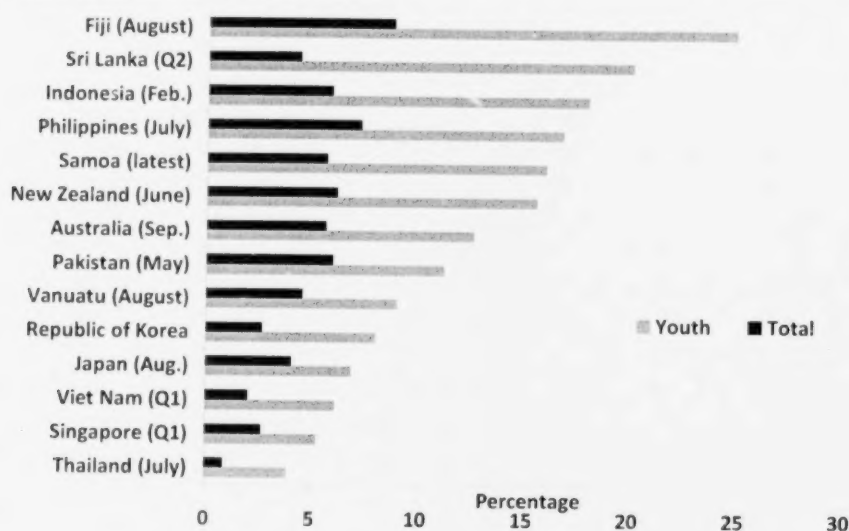
⁴ World Bank, "Land and Food Security", 2 October 2012. Available from web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTARD/0,contentMDK:23284610~pagePK:148956~piPK:216618~theSitePK:336682,00.html.

the nature and pattern of economic growth, which was not based on broad-based economy-wide development.

28. There are also concerns about job quality. A majority of workers in the region are informally employed or own-account or contributing family workers and have limited opportunities in finding work that is more productive, secure and salaried. Also, a large percentage of people in the region hold very low-paid jobs. The number of "working poor", those who earn less than \$2 a day, is highest in South and South-West Asia. The prevalence of working poor and vulnerable employment are clear manifestations of the lack of economic and social opportunities.

29. Young people in the region, in particular, struggle to find decent and productive employment (see figure 1). The youth unemployment rate is almost three times the adult unemployment rate. The high rate of youth unemployment is the result of several factors, such as lack of decent and productive jobs, the mismatch between education and employers' requirements, low secondary schooling completion rates, gender discrimination and high youth aspirations. Many countries now have a potential demographic dividend. Yet, to make the dividend a reality, they need to secure productive employment for the growing pool of young people, especially young women.

Figure 1
Total and youth unemployment rates in selected Asia-Pacific economies, 2013 or latest available data



Sources: ESCAP, based on data from the International Labour Organization and estimates from national labour force surveys. Pacific economies information obtained from the Secretariat of the Pacific Community.

Note: Total includes ages 15+; youth includes ages 15-24 except Pakistan (aged 15-19) and Singapore (residents aged 15-29); non-seasonally adjusted.

B. Inequality hampering sustainability of growth

30. Another key socioeconomic challenge in Asia and the Pacific is inequality. At the regional level, income inequality (the Gini coefficient) increased from 33.5 in the 1990s to 37.5 in 2010. At the national level, the Gini coefficient has increased in many major economies in recent decades. A

specific area of concern is gender inequality, which is intrinsically linked to the prevalence of gender-based violence in the region. These challenges continue to inhibit the full participation of women in public life. They affect not only the well-being of women themselves, but also that of their families and their communities, and can weaken social and economic stability.

31. High levels of income inequality seriously undermine economic and social achievements. For example, GDP per capita for many economies in the region declines significantly when adjusted for income inequality. The ESCAP social development index,⁵ which combines education and life expectancy, shows that inequality in several emerging and low-income economies is also having a serious impact on social development.

32. ESCAP analysis of country-level household debt and inequality data covering the post-crisis period, which is drawn from 81 developing countries globally, including 26 economies in the region, shows a positive association between inequality and household indebtedness. This finding conforms to recent research of the International Monetary Fund (IMF).⁶ With income growth lagging, the poorer sections of society tend to increase debt-financed consumption made possible by the availability of credit as higher income groups deposit their increasing wealth in the banking system. This trend could lead to ever-rising household debt in economies with growing inequality, making them vulnerable to shocks. As households spend more than they earn, countries increasingly face growing current account deficits, exacerbated by luxury imports by higher income groups.

IV. Policy options to deal with the challenges

A. Productive government spending to support sustainable growth

33. The obstacles to higher growth in Asia and the Pacific are not only slow economic recovery in the developed world, but also long-term structural impediments. This highlights the need for productive and countercyclical government macroeconomic support. Such policies can support growth in the short term while helping remove structural impediments in the long term. The ongoing reallocation of foreign capital away from the region as monetary policy in the United States is normalized will also increase the need for supportive policies for domestic investment. Some possible supportive measures are highlighted below.

34. *Social protection spending:* Increasing spending on social protection would help to support growth, as well as reduce inequality. Recognizing the importance and necessity of adequate social protection systems, the United Nations System Chief Executives Board adopted (April 2009) the Social Protection Floor Initiative, which was endorsed by the Member States at the United Nations Conference on Sustainable Development. Social protection is now a priority in the development agenda beyond 2015.⁷

⁵ *Economic and Social Survey of Asia and the Pacific 2012: Pursuing Shared Prosperity in an Era of Turbulence and High Commodity Prices* (United Nations publication, (Sales No. E.12.II.F.9).

⁶ Michael Kumhof and Romain Rancière, "Unequal = indebted", *Finance and Development*, vol. 48, No. 3 (September, 2011). Available from www.imf.org/external/pubs/ft/fandd/2011/09/Kumhof.htm.

⁷ United Nations, "Social protection: a development priority in the post-2015 UN development agenda" (UN System Task Team on the Post-2015 UN Development Agenda, 2012). Available from www.un.org/millenniumgoals/pdf/Think%20Pieces/16_social_protection.pdf.

35. Several countries in the region have recently initiated policies and programmes aimed at enhancing social welfare. There is a significant positive correlation between the extent of coverage of those policy measures and reductions in inequality as shown in the *Survey 2013*.⁸ Based on World Bank data,⁹ ESCAP has found that within a universal system, targeted social protection and labour market programmes are likely to reduce inequality. ESCAP has designed a social protection “toolbox”¹⁰ to facilitate policymakers in their effort to build robust social protection systems by enabling policymakers to identify gaps at the national level, while providing useful examples on how to move forward.

36. Achieving sustainable financing is an important challenge in efforts to boost access to and increase the depth of social protection measures. Critically, the design of social protection measures needs to take into account the growing challenges governments face in dealing with the ageing structure of populations. The private sector must also contribute to this effort and partner with governments. Some global and regional funds could be established by using innovative sources of financing. In this regard, regional initiatives were proposed in the ESCAP 2013 theme study.¹¹

37. *Infrastructure spending:* Governments need to address the significant shortage in infrastructure provision across the region. Apart from current needs, the demand for infrastructure is projected to increase significantly in line with growing populations and greater urbanization. An ESCAP study in 2006 estimated the infrastructure financing gaps in the Asia-Pacific region to be about \$600 billion per annum.¹² A more recent study by the Asian Development Bank (ADB) in 2009 put the figure at \$800 billion per annum over the period 2010-2020.¹³ The private sector alone is not coming close to closing these gaps, with annual spending on infrastructure over the past 20 years averaging \$13 billion per annum and being concentrated in less risky investments.

38. Existing forms of infrastructure investment in the region could be complemented by the establishment of a new large-scale lending facility using innovative development financing sources. Such an institution could issue securities in which the region's central banks would be able to park their surplus reserves. This facility could help coordinate other sources of lending, such as multilateral and bilateral development agencies and private financial institutions, while its backing of infrastructure projects could signal opportunities to private investors. As a regional mechanism, the facility could also be in a position to keep track of intraregional spillovers and finance economically significant cross-border projects, as well as provide advisory

⁸ *Economic and Social Survey of Asia and the Pacific 2013: Forward-looking Macroeconomic Policies for Inclusive and Sustainable Development* (United Nations publication, Sales No. E.13.II.F.2).

⁹ World Bank, ASPIRE database: The Atlas of Social Protection - Indicators of Resilience and Equity. Available from <http://datatopics.worldbank.org/aspire/>.

¹⁰ The Toolbox provides access to a database of more than 80 good practices in social protection from developing countries. For details see www.socialprotection-toolbox.org/.

¹¹ *Building Resilience to Natural Disasters and Major Economic Crises*. (United Nations publication, Sales No. E.13.II.F.3).

¹² *Enhancing Regional Cooperation in Infrastructure Development Including that Related to Disaster Management* (United Nations publication, Sales No. E.06.II.F.13).

¹³ Asian Development Bank and Asian Development Bank Institute, *Infrastructure for a Seamless Asia* (Tokyo, Asian Development Bank Institute, 2009). Available from www.adbi.org/files/2009.08.31.book.infrastructure.seamless.asia.pdf.

services and technical assistance in the financial design of infrastructure projects.

39. Apart from shortfalls in financing, there is a clear need to significantly improve legal and regulatory frameworks for infrastructure investment across much of the region. In recent years, such frameworks have lacked clarity, which has been a significant factor behind the worsening investment climates, resulting in a reduction in new projects throughout the region. Without improvements in regulatory frameworks and policy certainty, even in the presence of adequate financing, investors will remain reluctant to enter into major investments. Meanwhile, political instability is another factor that discourages private sector investment in large infrastructure projects.

40. *Environment-related spending:* Governments must undertake spending to address environmental factors which would otherwise hamper growth prospects. Environmental damage is already constraining growth in the region. For example, environmental degradation was estimated in 2012 to cost India almost 6% of GDP annually.¹⁴ Economic potential has also been adversely affected by the widespread loss of natural ecosystems and biodiversity.

41. Policies aimed at improving access to modern energy sources are also needed. Using such sources can make growth more sustainable and would contribute to increased growth by making households more productive. To improve access to modern energy, several countries have formulated investment strategies for energy infrastructure, which are aimed at improving energy efficiency and increasing the use of renewable sources.

42. Addressing climate change more effectively by improving climate finance must be considered in order to ensure sustainable growth. Sources of climate finance should be mobilized from both the public and private sectors. Public finance can be focused on leveraging private funding to tackle climate challenges. Specifically, climate finance mechanisms should be mainstreamed into the evolving financing framework in the context of the development agenda beyond 2015.

B. Investment in youth

43. The region is facing the enormous challenge of securing productive and decent employment for the largest generation of young people in history. This is crucial for reaping the demographic dividend. While some of the problems are caused by a lack of jobs, many young people are entering the labour force with skills that are limited or do not match the changing demands of labour markets.

44. Governments need to address the way in which youth develop from a young age and help prepare them for work with adequate knowledge, skills and experience. Active labour market programmes must be designed to effectively link education, training and skills development systems with the requirements of employers. The challenge of increasing access to education is especially great for low-income economies, where the probability of obtaining tertiary level education is low.

45. Efforts to improve education systems must focus particularly on gender inequalities. Although there has been marked improvement in this area in the region in recent years, there are still disparities that translate into untapped

¹⁴ World Bank, India - Diagnostic assessment of select environmental challenges: an analysis of physical and monetary losses of environmental health and natural resources, vol. I. Report No. 70004-IN (Washington, D.C., 2013).

productive potential for both medium- and long-term growth. Notably, the South and South-West Asian subregion is lagging, with eight girls for every 10 boys enrolled in secondary education, but an even greater concern is that only three women for every four men are enrolled in tertiary education. There are many barriers to female education, including the burden of household work, limited appreciation of the benefits of educating girls and women, and negative social and cultural attitudes. Addressing such prejudices requires greater investment in the recruitment of female teachers and targeted support for poor families so as to render educational establishments more female-friendly.

C. Mitigating risks from capital volatility

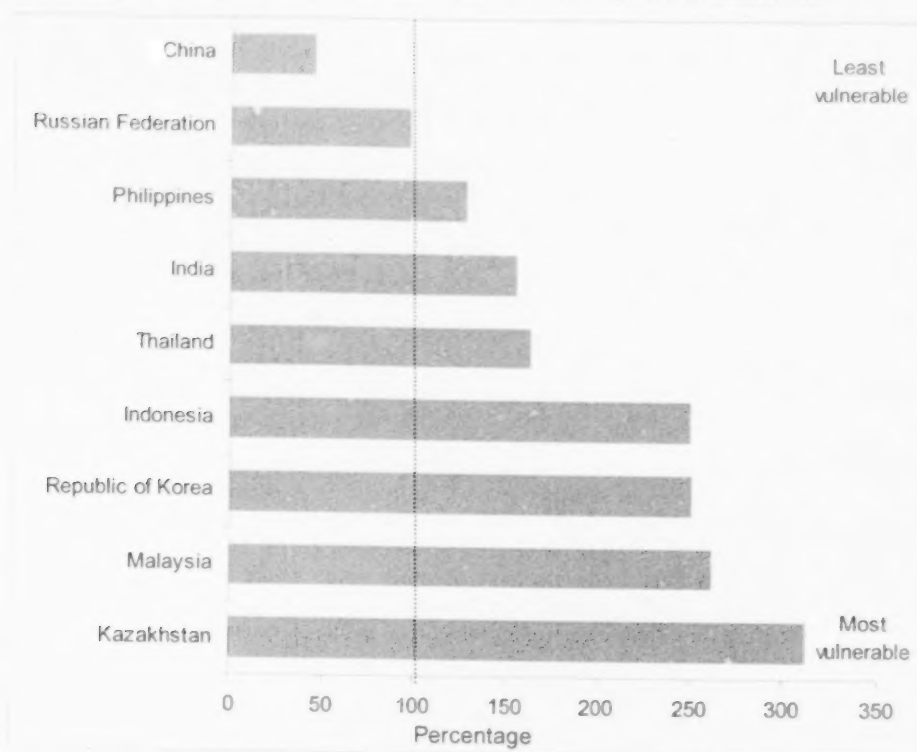
46. Economies in the region have managed the impact of capital flows volatility on their exchange rates through a combination of approaches, namely currency depreciation, using foreign exchange reserves and raising interest rates. For example, the Turkish lira depreciated by 7% against the dollar in January 2014. In the period June-August 2013, the largest currency depreciation was experienced by India (13%), followed by Indonesia, Malaysia, the Philippines, Thailand and Turkey (all between 6% and 9%). To prevent excessive depreciation of their currencies, countries used some of their foreign exchange reserves. India, Indonesia and Thailand saw the largest declines in their respective reserves, having used between \$11.5 billion and \$19.3 billion over the period January-August 2013. Some economies in the region also raised interest rates to manage the depreciation of their respective currencies. This approach not only increased the attractiveness of their currencies but helped policymakers mitigate the inflationary impact of depreciation on domestic prices. In January 2014, Turkey sharply raised its overnight lending rate from 7.75% to 12%, while India increased its repo rate by 25 basis points to 8%. During the earlier period of capital outflows, Indonesia increased its reference rate between May and November 2013 from 5.8% to 7.5%.

47. Countries should be vigilant about holding sufficient foreign exchange reserves. The ESCAP vulnerability yardstick considers the level of short-term foreign exchange commitments, comprising portfolio investment, short-term debt and quarterly imports, as a percentage of foreign reserves. It indicates that some economies in the region may have insufficient foreign exchange reserves to cover the exit of foreign funds from their financial markets and hence they face risks of excessive exchange rate depreciation (see figure 2).

48. Concerns about the lack of sufficient reserves at the national level to respond to the risks from capital flows volatility have underscored the need for greater regional support. Currency-related difficulties in various countries in 2013 highlighted the lack of use of current regional schemes, such as the Chiang Mai Initiative Multilateralization (CMIM). In recent instances, countries needing currency support, even those within ASEAN+3¹⁵, have used ad hoc regional sources of funds through numerous bilateral swap agreements. An alternative to current arrangements could be a comprehensive Asia-Pacific financial support mechanism using some of the sizable foreign reserves available to the region's governments. Such a mechanism is important even for countries that are currently covered by regional agreements, as currency crises in non-protected countries can cause contagion in an interconnected region.

¹⁵ Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam, China, Japan and Republic of Korea.

Figure 2
Vulnerability yardstick in selected Asia-Pacific economies, latest available data



Source: ESCAP, based on data from CEIC Data Company. Available from ceicdata.com/ (accessed 20 February 2014).

Note: Vulnerability yardstick is the sum of short-term external debt, latest quarterly imports based on four-quarter moving average and estimated international portfolio investment position, divided by foreign exchange reserves.

49. The use of foreign exchange reserves can stabilize currencies under pressure, but it is not effective in dealing with the negative impact sudden outflows have on asset markets. Therefore, as highlighted by the IMF,¹⁶ an important additional supportive measure can be capital flows management at the national level to deal with inflow/outflow surges in asset markets. Such measures have been gaining in popularity, as recommended by ESCAP over a number of years. Some recent capital account management measures have been market-based, such as taxes or levies on particular instruments, while others have been quantitative, such as putting caps or prohibitions on purchasing particular instruments. Most of these measures have been directed at capital inflows or purchases, but some have also been targeted at discouraging capital outflows or sales. A general guideline should be that such measures become a component of long-run policies to prevent economic booms and busts.

¹⁶ International Monetary Fund, "Liberalizing capital flows and managing outflows" (Washington, D.C., 2012). Available from www.imf.org/external/np/pp/eng/2012/031312.pdf; International Monetary Fund, "The liberalization and management of capital flows: an institutional view" (Washington, D.C., 2012). Available from www.imf.org/external/np/pp/eng/2012/111412.pdf.

V. Domestic resource mobilization: options for expanding fiscal space

50. Mobilizing domestic resources is necessary for funding the development needs of the region. There is a particular need to expand fiscal space, given large fiscal deficits in many countries.

51. Governments have a range of options for creating "fiscal space", including increasing levels of borrowing, making existing expenditure more efficient, reprioritizing expenditure to orient it more towards development or increasing tax and non-tax revenues. The option of expanding indebtedness can be risky, even when levels of debt are relatively low. For one, future debt servicing represents a drain on resources. Net interest payments already consume a quarter of total revenue in India, a third in Pakistan and a fifth in the Philippines. Other risks from borrowing are a potential rise in interest rates and maturity mismatches. Higher levels of foreign-denominated debt can also constrain countercyclical macroeconomic policy.

52. Governments can, of course, create fiscal space by making better use of existing resources. One way would be to reduce expenditure on non-priority areas. A target for cuts would be defence expenditure, which in several countries exceeds that on health and education combined and makes little if any contribution to development. Another option would be to reduce various kinds of poorly targeted consumption subsidies which in many countries account for a significant proportion of total public expenditure.

53. Primarily, governments need to raise more revenue, especially from taxes. Tax collection in Asia-Pacific developing countries is neither sufficient nor equitable. Based on past experience across the region, there appear to be numerous opportunities for improving all forms of taxation, direct and indirect, whether for corporations or individuals. In fact, many countries have been able to strengthen tax revenues over the past decade.

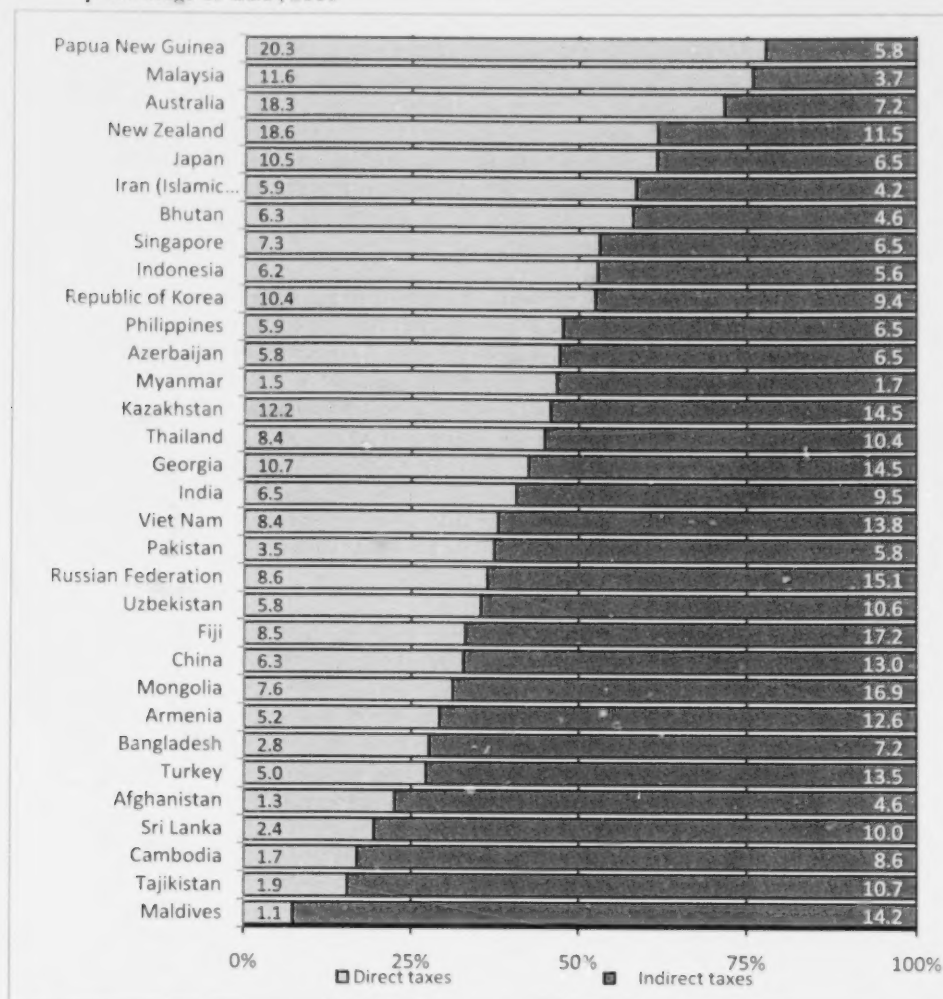
54. Tax collection of central governments in developing Asia-Pacific averaged only 14.8% of GDP in 2011, compared to 17.1% of GDP in Latin America and the Caribbean and 16.3% in Sub-Saharan Africa. Only seven countries (of which four were resource-rich) collected tax revenues of more than 20% of GDP in 2011, while in several others, tax-to-GDP ratios were in single digits.¹⁷ This is far from the 25% to 35% of GDP that is considered one of the prerequisites for being able to provide the necessary financing and expenditure to become a developed country.

55. The composition of tax revenues is just as important as the level of revenues. Indirect taxes are the largest source of tax revenue in more than half of the countries in the region (see figure 3), however, their contribution to total tax revenue has been declining in most countries. A substantial component of indirect taxes in the region, particularly in the Pacific, is on international trade. To encourage trade, many economies have in recent years reduced trade taxes and focused on taxes on goods and services, such as value added taxes (VAT) or general sales taxes (GST). Revenues from VAT or GST have on average risen from less than a fifth of indirect taxes to around one half since 1990, but in many countries, such as Malaysia, Pakistan and Vanuatu, they have not offset the fall in revenues from taxes on trade.

¹⁷ World Bank, "World Bank development indicators". Available from data.worldbank.org/data-catalog/world-development-indicators.

Figure 3

Share of direct and indirect taxes in tax revenue, and tax revenues as a percentage of GDP, 2011



Source: ESCAP calculations based upon IMF GFS, accessed November 2013, and official data sources.

Note: The numbers inside the figure denote the size of the respective taxes in terms of percentage of GDP. Data are for 2011 except for: Myanmar and Tajikistan (2004), Afghanistan (2007), Bhutan and Iran (Islamic Republic of) (2009), Maldives, Cambodia and China (2010).

56. Over the last two decades, about two thirds of the countries with available data have seen increases in direct tax revenues, comprising taxes on income, profits and capital gains, payrolls and property income. For instance, in Bhutan, India, Malaysia and Pakistan, the share of direct taxation in overall tax revenues has increased by about a quarter. This shift is generally desirable as indirect taxes affect prices and thus influence resource reallocation. Moreover, growth of indirect tax revenue, especially GST, always falls behind the growth of income or GDP as expenditure does not grow as income. As a result, GST needs to be adjusted periodically in terms of rate and coverage. Indirect taxation tends to be more regressive, but it also encourages tax evasion

or a cash economy. In contrast, direct taxes are more equitable as they can be progressive, with higher rates at higher levels of income.

57. Yet, in most countries less than half of tax revenues are raised directly. Moreover, increases in revenue from direct taxes have tended to be relatively small. One reason for this is that in many countries, personal income tax revenues are low, especially where a large proportion of the labour force is active in the informal sector or in agriculture. Wealthier individuals in many countries also may pay little income tax as a result of tax avoidance and non-compliance. In several countries, less than 1% of the population pays income tax.

A. Monitoring tax revenues

58. Governments need to be able to monitor their tax systems closely. One measure is "tax buoyancy", which captures the responsiveness of tax revenues to changes in output without distinguishing between discretionary and automatic growth of revenue. Between 2007 and 2012, tax buoyancy was mixed. It was greater than 1 in 12 out of 20 countries with available data, indicating that in those countries tax revenues increased at a higher rate than output. Among them, the four least developed countries, namely Bangladesh, Bhutan, the Lao People's Democratic Republic and Nepal, had buoyancy coefficients greater than 1.5. As tax-to-GDP ratios are less than 15% in those countries, higher buoyancies augur well for the future as tax-to-GDP ratios will increase as levels of output grow.

59. Tax revenues of most of the countries in the region are below their potential. Clearly, a country's ability to raise taxes depends on many factors — structural, developmental, institutional and socioeconomic.¹⁸ When judging a country's capacity for raising more tax revenue, it is important to consider these factors. Analysis that takes structural factors, such as income per capita, the share of agriculture in output and the openness of the economy into account, shows that the tax potential can be quite significant. In several countries, the gap between actual revenues collected and the level that would be appropriate given the economy's structure is equivalent to 5% of GDP or more (see table). By embracing their tax potential and closing existing tax gaps, the economies of Afghanistan, Bangladesh, Bhutan, the Islamic Republic of Iran and Hong Kong, China would be able to raise their tax revenues by more than 70%.

60. One of the reasons behind the region's low tax revenues may be its relatively low tax rates. For instance, the average corporate tax rate for Asia and the Pacific was 28.2%, as compared to 32.2% for Latin America and the Caribbean and 29.8% for Africa. Corporate tax rates are often low because countries have reduced them to attract FDI. Thus, over the past seven years, two thirds of a sample of 24 countries from the region reduced their corporate tax rates. Countries that made large reductions were China, from 33% to 25%, Sri Lanka, from 32.5% to 28%, and Thailand, from 30% to 20%. However, the impacts of those reductions on FDI are not clear. If foreign investors can offer something extra compared with domestic investors, it may be useful to offer them special incentives.¹⁹ If this is not the case, preferential tax treatment distorts competition and puts local companies at a disadvantage.

¹⁸ Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (New York, McGraw-Hill, 1989).

¹⁹ Magnus Blomström, Ari Kokko and Jean-Louis Mucchielli, *The Economics of Foreign Direct Investment Incentives* (Heidelberg, Berlin, Springer, 2003).

Table
Estimated tax potential in selected Asian economies

Countries/areas	Year	Tax-to-GDP Ratio		Tax gap	Tax gap as proportion of current tax revenue
		Actual	Potential		
Afghanistan	2011	8.8	15.0	6.2	70.5
Azerbaijan	2012	12.9	15.1	2.1	16.6
Bangladesh	2013	10.5	18.0	7.5	72.1
Bhutan	2009	9.2	16.0	6.7	72.9
Cambodia	2011	10.0	13.0	3.0	30.4
China	2012	19.4	21.2	1.8	9.4
Hong Kong, China	2011	14.2	26.7	12.5	88.1
Indonesia	2012	11.9	16.6	4.7	39.3
Iran, Islamic Republic of	2013	5.8	13.1	7.2	124.5
Japan	2012	17.0	19.3	2.2	13.1
Malaysia	2012	16.1	17.4	1.3	7.9
Maldives	2010	10.7	16.5	5.8	54.2
Nepal	2013	15.2	16.1	0.9	5.6
Pakistan	2012	10.3	12.1	1.8	17.3
Philippines	2012	12.9	14.3	1.5	11.4
Singapore	2011	13.8	20.7	6.9	50.3
Thailand	2011	18.8	19.0	0.2	0.9

Source: ESCAP calculations.

Note: The tax gap is calculated by taking the difference between the estimated tax potential and the actual tax-to-GDP ratio for a given country in the year with most recent data. Only countries with a positive tax gap are listed in this table.

61. Many countries are not tapping their tax potential to the fullest extent. This is due to the liberal use of exemptions and concessions, which are also reducing the scope for tax progressivity in the region. Tax exemptions and allowances can, for instance, take the form of tax holidays, reduced corporate income tax rates, investment tax allowances and partial profit exemptions to reduce the cost of capital. At the individual level, they include tax deductions and credits for a wide range of items. Many countries also set lower tariffs on imports than their most favoured nation (MFN) rate would allow. This reduces customs and import duties. Also, tax exemptions and difficulties in implementing VAT/sales taxes contribute to lower tax revenues.

62. Tax concessions can be useful, especially if they lead to higher investment or higher growth. The revenues foregone ("tax expenditures") due to these deductions and allowances can be significant. In Georgia, the Philippines and Tajikistan, tax expenditure in corporate income tax reaches 0.5% of GDP or more. Tax expenditures in customs duties account for more than 1% of GDP in Pakistan and in the Philippines and more than 8% of GDP in China.

B. Policy options to enhance tax revenues

63. Countries with untapped tax potential can enhance tax revenues in a number of ways, such as broadening tax bases and rationalizing tax rates, tackling tax evasion and tax fraud, making tax administrations more effective

and transparent, carefully sequencing reforms of tax policy and tax administration, and strengthening regional cooperation.

64. Governments can take a number of measures to rationalize and extend their tax systems to have larger tax bases with relatively low tax rates that do not create distortions in the allocation of resources. Countries should review their indirect taxes and retain only exemptions or concessions that are achieving their stated objectives. GST and VAT systems should be made simpler. This would also entail extending these taxes to sectors that are currently exempt. There is also a case for expanding the base for customs duties to the import of services, as has already been done in some countries.

65. Revenues from direct taxes should be strengthened by implementing mechanisms for taxing capital gains in securities or property more widely. Also, appropriate mechanisms must be developed to apportion domestic and foreign operations of multinational corporations properly so that there is no loss of tax revenues. This also includes harmonizing income tax rates so that ideally the rate is the same for companies and high-income individuals in order to preserve tax progressivity and prevent income shifting to reduce tax liabilities.

66. Tackling tax evasion and tax fraud is a priority, especially considering that for the period 2001-2010, illicit capital outflows from developing countries globally totalled up to \$5.9 trillion, for which the region accounted for more than 61%. To deal with the tax evasion and non-compliance, countries can introduce minimum taxes on companies and associations of person. They can address evasion of personal income tax through withholding or advance taxes and can enhance VAT revenues by increasing incentives for compliance through simpler procedures and more rapid processing of refund claims. In addition, they should consider the creation of special tax courts to tackle tax evasion and tax fraud.

67. Making a tax system equitable and efficient requires a tax administration that is free from corruption, political interference and pressure from vested interests. In many countries, a careful sequencing of reforms to tax policy and to tax administration is needed. In the first phase of reform of tax administrations, human capacity must be expanded and administrations should be organized along functional lines, in which for instance, a single department is responsible for processing returns and payments, another for audits and investigations and yet another for enforcing collections. Also, information technology systems should be integrated. In a second phase, tax bases should be broadened by detecting new tax payers and providing greater incentives for compliance. Finally, tax assessments should be based on collateral evidence collected across government departments and compliance could be strengthened further by reducing the multiplicity of taxes.

68. Reforming tax policy necessitates that governments broaden tax bases by expanding upon withholding taxes and advance tax regimes, and by reducing exemptions and concessions. Also, VAT should be expanded to cover both goods and services, maintaining measures that offset their disproportionate impact on low-income persons. Tax rates should then be rationalized to reduce distortions and remove any existing tax anomalies. Finally, legislation should be strengthened to regulate transfer pricing and to determine global incomes liable for taxation.

69. Greater regional cooperation can play an important role in mobilizing tax revenues. While competition for FDI is leading to a "race to the bottom" in terms of taxation of profits of multinational companies, tax harmonization among countries, especially those belonging to regional associations, such as

the Association for Southeast Asian Nations (ASEAN) and the South Asian Association for Regional Cooperation (SAARC), may boost revenues. Effective regional cooperation can be used to help avoid double taxation, to combat transfer pricing by multinational corporations and to deal with tax havens.

70. Given the evidence of the status of tax collection in the region, there is a strong case for establishing an Asia-Pacific tax forum under the aegis of ESCAP. This forum could monitor the tax legislation of member countries and publish a regular review of tax reforms. It could also act as a repository of tax laws, hold seminars/workshops on emerging tax-related issues and share best practices in tax policies, tax administration and tax reforms.